

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Garcia Analyst: Darrine Distefano Bill Number: AB 2227
Related Bills: See Legislative History Telephone: 845-6458 Amended Date: April 27, 2004
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Manufacturing Enhancement Area Incentives/Targeted Tax Area and LAMBRA Designation Authority Is Department of Housing and Community Development

SUMMARY

This bill would add tax incentives to the Manufacturing Enhancement Area (MEA) program.

SUMMARY OF AMENDMENTS

The April 27, 2004, amendments delete the previous provisions relating to MEA incentives and added the language discussed in this analysis.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to expand the tax incentives offered in the MEA in order to support existing businesses, increase economic development, and attract more businesses to the MEA.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative beginning on or after January 1, 2005.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are provided to correct technical concerns and other related tax incentive provisions.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law provides special tax incentives for empowerment zones and enterprise communities to provide economic revitalization of distressed urban and rural areas.

Board Position:

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Department Director

Date

Will Bush for Gerald H. Goldberg 5/13/04

Qualified zone businesses operating in federal empowerment zones and federal enterprise communities are eligible to receive two tax incentives: (1) tax-exempt private activity bonds to finance certain facilities; and (2) the "brownsfields" tax incentive, which allows taxpayers to expense (rather than capitalize) certain environmental remediation expenditures. Qualified empowerment zone businesses are allowed an additional \$20,000 depreciation expense deduction.

Under the Government Code, existing state law provides for the designation of MEAs. Using specified criteria, the former Technology, Trade, & Commerce Agency (TTCA) designated two MEAs from the applications received from the governing bodies. Each MEA is binding for 15 years beginning January 1, 1998. TTCA may audit MEA programs at the end of the fifth and 10th year to determine how effective the program has been in attracting manufacturing facilities and creating employment opportunities. Beginning in 2004, Department of Housing and Community Development (DHCD) has assumed TTCA's responsibilities with respect to MEAs.

Under the Revenue and Taxation Code (R&TC), existing state law provides a hiring credit for taxpayers conducting business activities within a MEA. The hiring credit is allowable to businesses located in a MEA for a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated a MEA and meet certain other criteria. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on MEA income.

Besides the hiring credit, there are other special tax incentives offered to taxpayers operating a business in an Enterprise Zone (EZ), Local Agency Military Base Recovery Act (LAMBRA), and Targeted Tax Area (TTA), collectively known as economic development areas (EDAs). These incentives are as follows:

- Sales or use tax credit
 - A business located in an EDA is allowed a credit for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an EDA (except a MEA).
- Business expense deduction
 - A business may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the EDA.
- Special net operating loss (NOL) treatment
 - A business located in an EDA may elect to carry over 100% of the EDA NOLs to deduct from EDA income of future years.
- Net interest deduction
 - A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an EZ.
- Employee wage credit
 - A tax credit for employees working in an EZ for taxpayers conducting business activities within the EZs.

For businesses operating inside and outside an EDA, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax on income attributable to the EDA.

The following table shows the incentives available to each of the EDAs.

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

Only the hiring credit is available to taxpayers operating within a MEA.

THIS BILL

This bill would add the term “department” to identify DHCD, instead of TTCA, as the agency for designating EDAs.

This bill would add the sales and use tax credit, business expense deduction, net interest deduction, and special NOL treatment as tax benefits available for MEAs. If a MEA successfully completes a fifth year audit, these incentives would be allowed to taxpayers that operate a business within the MEA.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

TECHNICAL CONSIDERATIONS

If a taxpayer qualifies for special NOL treatment under more than one EDA, the taxpayer must choose which EDA to elect and carryforward for the NOL. Each of the EDA NOL provisions reference’s the other EDA NOL provisions that can be elected. Under the MEA NOL provision, the TTA and LAMBRA NOL sections are referenced except for the EZ NOL. The EZ NOL reference needs to be added to the MEA NOL provision. Amendments 1 and 2 are provided to correct this technical concern.

Also, since this bill is adding the MEA NOL provisions, the current EDA NOL sections need to be amended to include reference to the new MEA NOL section. Also, the definition of a “qualified taxpayer” for the EDA NOLs needs to be amended to include the MEA NOL reference. Amendments 3 and 4 are provided.

LEGISLATIVE HISTORY

SB 200 (Kelley, Ch. 609. Stat. 1997) authorized a new type of economic development area called “MEA” and provided a hiring credit for qualified taxpayers operating in a MEA. This law also amended existing EZ incentives to clarify that taxpayers operating in MEAs are only allowed a hiring credit.

OTHER STATES' INFORMATION

Currently, 29 other states have EDAs that provide similar tax related incentives to those provided in California's EDAs. The number of EDAs varies from state to state. For example, California currently has 49 EDAs (that include EZs (39), MEAs (2), LAMBRAs (7), and TTA (1)), New York has 71, Florida 51, Illinois 93, and Michigan 33.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The projected increase in revenue losses from additional sales/use tax credits and other specified tax incentives are as follows:

Fiscal Year Cash Flow Impact of AB 2227 Assumed Enacted After 6/30/2004		
2004-5	2005-6	2006-7
\$500,000	\$500,000	\$500,000

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Revenue Discussion

The amount of revenue losses under this bill would depend on the number of taxpayers with purchases of qualified property made after January 1, 2001, the latest date a taxpayer can file an amended return, the amount of sales/use tax paid, and the likelihood that impacted taxpayers would file an amended return within the applicable statute of limitations. Also, with respect to the net interest deduction for lenders, the revenue impact would depend on the number of qualified loans and the amount of interest paid by eligible MEA businesses.

Brawley and Calexico were established as MEAs in October 1998 and expire in December 2012. These two rural cities have had little impact on state revenues over the years, averaging less than \$150K per year during 1999-2001. In light of the revenue impact associated with MEAs under current law, the extension of the specified tax incentives under proposed law is projected to be less than \$500,000.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2227
As Amended April 27, 2004

AMENDMENT 1

On page 15, line 10, after "Section" insert:

17276.2,

AMENDMENT 2

On page 22, line 38, after "Section" insert:

24416.2,

AMENDMENT 3

On page 15, between lines 17 and 18, insert:

Sec. 8. Section 17276.1 of the Revenue & Taxation Code is amended to read:

(a) A qualified taxpayer, as defined in Section 17275.7, 17276.2, 17276.4, 17276.5, 17276.6, or 17276.7, may elect to take the deduction provided by Section 172 of the Internal Revenue Code, relating to the net operating loss deduction, as modified by Section 17276, with the following exceptions:

(1) Subdivision (a) of Section 17276, relating to years in which allowable losses are sustained, shall not be applicable.

(2) Subdivision (b) of Section 17276, relating to the 50-percent reduction of losses, shall not be applicable.

(b) The election to compute the net operating loss under this section shall be made in a statement attached to the original return, timely filed for the year in which the net operating loss is incurred and shall be irrevocable. In addition to the exceptions specified in subdivision (a), the provisions of Section 17275.7, 17276.2, 17276.4, 17276.5, 17276.6, or 17276.7, as appropriate, shall be applicable.

(c) Any carryover of a net operating loss sustained by a qualified taxpayer, as defined in subdivision (a) or (b) of Section 17276.2 as that section read immediately prior to January 1, 1997, shall, if previously elected, continue to be a deduction, as provided in subdivision (a), applied as if the provisions of subdivision (a) or (b) of Section 17276.2, as that section read prior to January 1, 1997, still applied.

Sec. 9. Section 17276.2 of the Revenue and Taxation Code is amended to read:

@@@Note to Legislative Counsel: Insert Section 17276.2 of the Revenue & Taxation Code subdivisions (a) through (b) and amend:

(c) If a taxpayer is eligible to qualify under this section and either Section 17275.7, 17276.4, 17276.5, or 17276.6 as a "qualified taxpayer," with respect to a net operating loss in a taxable year, the taxpayer shall designate which section is to apply to the taxpayer.

(d) Notwithstanding Section 17276, the amount of the loss determined under this section or Section 17275.7, 17276.4, 17276.5, or 17276.6 shall be the only net operating loss allowed to be carried over from that taxable year and the designation under subdivision (b) shall be included in the election under Section 17276.1.

Sec. 10. Section 17276.5 of the Revenue and Taxation Code is amended to read:

@@@Note to Legislative Counsel: Insert Section 17276.5 of the Revenue & Taxation Code subdivisions (a) through (b) and amend:

(c) If a taxpayer is eligible to qualify under this section and either Section 17275.7, 17276.2, 17276.4, or 17276.6 as a "qualified taxpayer," with respect to a net operating loss in a taxable year, the taxpayer shall designate which section is to apply to the taxpayer.

(d) Notwithstanding Section 17276, the amount of the loss determined under this section or Section 17275.7, 17276.2, 17276.4, or 17276.6 shall be the only net operating loss allowed to be carried over from that taxable year and the designation under subdivision (b) shall be included in the election under Section 17276.1.

(e) This section shall apply to taxable years beginning on or after January 1, 1998.

Sec. 11. Section 17276.6 of the Revenue and Taxation Code is amended to read:

@@@Note to Legislative Counsel: Insert Section 17276.6 of the Revenue & Taxation Code subdivisions (a) through (b) and amend:

(c) If a taxpayer is eligible to qualify under this section and either Section 17275.7, 17276.2, 17276.4, or 17276.5 as a "qualified taxpayer," with respect to a net operating loss in a taxable year, the taxpayer shall designate which section is to apply to the taxpayer.

(d) Notwithstanding Section 17276, the amount of the loss determined under this section or Section 17275.7, 17276.2, 17276.4, or 17276.5 shall be the only

net operating loss allowed to be carried over from that taxable year and the designation under subdivision (b) shall be included in the election under Section 17276.1.

(e) This section shall apply to taxable years beginning on or after January 1, 1998.

@@@Note to Legislative Counsel: Renumber subsequent sections

AMENDMENT 4

On page 23, after line 5, insert:

Sec. 16. Section 24416.1 of the Revenue & Taxation Code is amended to read:

(a) A qualified taxpayer, as defined in Section 24415.5, 24416.2, 24416.4, 24416.5, 24416.6, or 24416.7, may elect to take the deduction provided by Section 172 of the Internal Revenue Code, relating to the net operating loss deduction, as modified by Section 24416, in computing net income under Section 24341, with the following exceptions to Section 24416:

(1) Subdivision (a) of Section 24416, relating to years in which allowable losses are sustained, shall not be applicable.

(2) Subdivision (b) of Section 24416, relating to the 50-percent reduction of losses, shall not be applicable.

(3) The provisions of subparagraphs (B) and (C) of Section 172 (b) (1) of the Internal Revenue Code shall not apply. To the extent applicable to California law, net operating losses attributable to entities with losses described by Section 172(b)(1)(J) shall be applied in accordance with Section 172(b)(1)(A) and (B) of the Internal Revenue Code.

(b) Corporations whose income is subject to the provisions of Section 25101 or 25101.15 shall make the computations required by Section 25108.

(c) The election to compute the net operating loss under this section shall be made in a statement attached to the original return, timely filed for the year in which the net operating loss is incurred and shall be irrevocable. In addition to the exceptions specified in subdivision (a), Section 24415.5, 24416.2, 24416.4, 24416.5, 24416.6, or 24416.7, as appropriate, shall be applicable.

(d) Any carryover of a net operating loss sustained by a qualified taxpayer, as defined in subdivision (a) or (b) of Section 24416.2 as that section read immediately prior to January 1, 1997, shall, if previously elected, continue to be a deduction, as provided in subdivision (a), applied as if the provisions of subdivision (a) or (b) of Section 24416.2, as that section read prior to January 1, 1997, still applied.

Sec. 17. Section 24416.2 of the Revenue and Taxation Code is amended to read:

@@@ Note to Legislative Counsel: Insert Section 24416.2 of the Revenue & Taxation Code subdivisions (a) through (b) and amend:

(c) If a taxpayer is eligible to qualify under this section and either Section 24415.5, 24416.4, 24416.5, or 24416.6 as a "qualified taxpayer," with respect to a net operating loss in a taxable year, the taxpayer shall designate which section is to apply to the taxpayer.

(d) Notwithstanding Section 24416, the amount of the loss determined under this section, or Section 24415.5, 24416.4, 24416.5, or 24416.6 shall be the only net operating loss allowed to be carried over from that taxable year and the designation under subdivision (b) shall be included in the election under Section 24416.1.

Sec. 18. Section 24416.5 of the Revenue and Taxation Code is amended to read:

@@@Note to Legislative Counsel: Insert Section 24416.5 of the Revenue & Taxation Code subdivisions (a) through (b) and amend:

(c) If a taxpayer is eligible to qualify under this section and either Section 24415.5, 24416.2, 24416.4, or 24416.6 as a "qualified taxpayer," with respect to a net operating loss in a taxable year, the taxpayer shall designate which section is to apply to the taxpayer.

(d) Notwithstanding Section 24416, the amount of the loss determined under this section or Section 24415.5, 24416.2, 24416.4, or 24416.6 shall be the only net operating loss allowed to be carried over from that taxable year and the designation under subdivision (b) shall be included in the election under Section 24416.1.

(e) This section shall apply to taxable years beginning on and after January 1, 1998.

Sec. 19. Section 24416.6 of the Revenue and Taxation Code is amended to read:

@@@Note to Legislative Counsel: Insert Section 24416.6 of the Revenue & Taxation Code subdivisions (a) through (b) and amend:

(d) If a taxpayer is eligible to qualify under this section and either Section 24415.5, 24416.2, 24416.4, or 24416.5 as a "qualified taxpayer," with respect to a net operating loss in a taxable year, the taxpayer shall designate which section is to apply to the taxpayer.

(e) Notwithstanding Section 24416, the amount of the loss determined under this section or Section 24415.5, 24416.2, 24416.4, or 24416.5 shall be the only net operating loss allowed to be carried over from that taxable year and the designation under subdivision (c) shall be included in the election under Section 24416.1.

(f) This section shall apply to taxable years beginning on or after January 1, 1998.